U.S. SENATOR PETER G. FITZGERALD

Mutual Fund Reform Act of 2004

The Mutual Fund Reform Act of 2004 (MFRA) restores truly fiduciary fund governance, simplifies fund fees, confronts trading abuses, creates a culture of compliance, and eliminates the conflict-riddled shadow transactions that drive up costs. The essence of the legislation is not any regulatory regime it creates, but the market forces it liberates. Obscurity is the enemy of a free market. Too little information—and too much incomprehensible information—equally undermine informed investor decision-making. The Mutual Fund Reform Act lifts the veil off mislabeled and misleading transactions, ensures genuine transparency, and promotes true price competition.

With 95 million American stakeholders, mutual funds are truly America's investment vehicle of choice. MFRA strives above all to preserve the attractiveness of mutual funds as a flexible and investor-friendly vehicle for long-term, diversified investment. That goal requires a careful balancing of accountability and incentive—or carrot and stick. Federal and state governments cannot police, much less micromanage, over 8,000 funds. The overriding duty to shareholders rests primarily with the funds themselves, and secondarily with the funds' service providers—each guided by a clearer statement of purpose and priority, incentivized by a more robust and transparent market that rewards low cost and good performance—*because it can truly identify them*—and accountable for failures that privilege fund managers' or brokers' interests over shareholders.

Vanguard Founder and industry savant John Bogle calls the Mutual Fund Reform Act of 2004 "the gold standard in putting mutual fund shareholders back in the driver's seat." The Consumer Federation of America says the Mutual Fund Reform Act of 2004 "will save mutual fund investors potentially tens of billions of dollars a year by wringing out excess costs." The Securities and Exchange Commission's (SEC) recent spate of regulatory initiatives is a testament to Washington's will in redressing the scandals and excessive fees that erode America's retirement and college savings. But the SEC cannot take the range of initiatives that are necessary to rationalize an industry governed by 64-year-old legislation. It is time for Congress to take the step that truly empowers America's investors and invigorates market forces. It is time for reforms that finally put investors first.

MFRA is divided into four titles: Title 1 (Fund Governance); Title 2 (Fund Transparency); Title 3 (Fund Regulation and Oversight); and Title 4 (Studies). The provisions under each title are analyzed below.

Title 1: Fund Governance

> *"Congress' purpose in structuring the [Investment Company] Act as it did is clear. It was designed to place the unaffiliated directors in the role of 'independent watchdogs,' who would furnish an independent check upon the management of investment companies."*
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> – *Burks v. Lasker*, 441 U.S. 471, 484 (1979).

✓ **Independent Directors**

The Mutual Fund Reform Act empowers a truly independent board of directors to exercise its essential "watchdog" role as the original Investment Company Act of 1940 envisioned. An inherent tendency to defer to authority—or to parties with more information—must be countered with both numbers *and* authority for the board to reliably flex its independent muscle in the best interests of shareholders. Thus, at least 75% of the board must be independent – including the chair.

That independence must be self-perpetuating. Thus, independent directors will nominate new directors and adopt qualification standards for such nomination.

Close relationships with fund advisers, or other significant service providers, can easily compromise independence. Thus, the legislation tightens the definition of independence to exclude individuals with material business or close family relationships with such service providers. Further, the legislation directs the SEC to study whether substantial aggregate compensation from a fund adviser, especially when directors serve on multiple boards, compromises independence.

✓ **Directors' Fiduciary Duty**

> ***"The national public interest and the interest of investors are adversely affected ... when investment companies are organized, operated, and managed in the interest of investment advisers, rather than in the interest of shareholders ... or when investment companies are not subjected to adequate independent scrutiny."***
>
> **--**Preamble to the Investment Company Act of 1940

Building on the ringing declaration in the Investment Company Act's Preamble, section 36(a) refers specifically to the fiduciary duty of directors—but it has been a relatively empty reference. Merely to recite "fiduciary duty," it appears, will not ensure fidelity to it. Directors need direction—and content—in discharging their fiduciary duties. MFRA supplies both. MFRA amends the Investment Company Act to make expressly clear that the directors' fiduciary duty obliges them to act in the best interests of shareholders.

A "fiduciary" duty is supposed to be a rigorous one—yet its content has been unenforced guesswork. Mindful of the industry's complexity, MFRA thus directs the SEC to provide directors with specific guidance on the content of their fiduciary duty. Such content will include, at a minimum, determining the extent to which independent and reliable sources of information are sufficient to discharge director responsibilities, negotiating management and advisory fees with due regard for the actual cost of services, including economies of scale, evaluating management quality and considering potentially superior alternatives, evaluating the quality, comprehensiveness, and clarity of disclosures to shareholders regarding costs, evaluating any distribution or marketing plan of the company, including its costs and benefits, evaluating the size of the fund's portfolio and its suitability to the interests of shareholders, implementing and monitoring policies and procedures to ensure compliance with applicable securities laws, and implementing and monitoring policies with respect to predatory trading practices, such as market timing.

✓ **<u>Investment Advisers' Fiduciary Duty</u>**

> ***"Money management has become a business instead of a profession. A profession is where the client comes first."***
>
> —Peter Bernstein, consultant and financial historian

After Wharton School and SEC studies in the 1960s found that mutual fund shareholders pay excessive fees because they lack bargaining power, the SEC recommended to Congress that it require that fees be "reasonable." That did not happen. Instead, in 1970, Congress imposed a "fiduciary" duty on fund advisers with respect to fees. As with the directors' "fiduciary" duty, however, the term lost any meaningful mooring in client-first professional stewardship. Indeed, in a watershed judicial interpretation of the adviser's "fiduciary" duty under section 36(b), the Second Circuit deemed the duty satisfied *unless* the adviser charged "a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining." *Gartenberg v. Merrill Lynch Asset Mgt., Inc.*, 694 F.2d 923 (2d Cir. 1982). Against such a startling hurdle, <u>no plaintiff ever wins an excessive fee case</u>—and the SEC has declined to hold fund directors accountable for failing adequately to review adviser fee agreements (under section 36(a)).

Once again, merely invoking the phrase "fiduciary" will not ensure fair stewardship. MFRA makes clear that the fund adviser's fiduciary duty with respect to fees "may require reasonable reference to actual costs of the adviser and economies of scale." <u>Advisers are entitled to a fair profit—and nothing in MFRA "caps" or "legislates" fees,</u>

or otherwise imposes a "price control." But MFRA *does* ensure that accountability is fairly allocated in the interests of shareholders.

MFRA also addresses another fiduciary deficit in the relationship between fund adviser and fund director. Conscientious independent directors may experience reckless intimidation and misdirection trying to penetrate the adviser's monopoly on critical fund information. Indeed, as Fund Democracy founder Mercer Bullard noted three years ago, under the current regime, "fund directors who try to do their jobs may do so at their own risk. In 1997, the directors of the Navellier Aggressive Small-Cap fund complained to the SEC that the fund's adviser, Louis Navellier, had refused to provide information they needed to evaluate his services. … Intent on proving that no good deed goes unpunished, Navellier dragged the fund's directors through years of litigation," which was finally resolved in the directors' favor.

Subjecting directors to the sufferance of fund advisers turns the fiduciary duties of both on their heads. MFRA cures this damaging imbalance by specifying that fund advisers owe a specific fiduciary duty to provide information that is material to fund governance. In other words, directors will no longer be obliged to think of every possible question necessary to obtain essential information—much less be bullied by resistant advisers.

✓ Termination of Fund Adviser

When fund managers cease to perform as effective stewards of the investments entrusted to them, they should be subject to the market discipline facing most Americans on the job—termination. Independent directors, exercising their fiduciary duties in the best interests of shareholders, should have the latitude to replace fund managers without undue fear of reprisal, spurious litigation, and other tactics by recalcitrant advisers. MFRA accordingly directs the SEC to issue regulations that facilitate the process by which independent directors, upon critical evaluation of fund management, terminate the services of fund management in the exercise of their fiduciary duties without undue exposure to financial or litigation risk.

✓ Independent Accounting and Auditing

Last December, *Business Week* magazine called for Congress to "reverse the embarrassing exemption it gave to the mutual-fund industry from the Sarbanes-Oxley corporate reform law's requirement that outside auditors evaluate internal controls." MFRA requires an audit committee, with requirements that track Sarbanes-Oxley provisions, and selection by that committee of an independent accountant.

✓ <u>Compliance Provisions</u>

MFRA, like S.1971 introduced by Senators Corzine and Dodd, draws significant inspiration from the lessons of the corporate scandals that gave rise to the Sarbanes-Oxley Act of 2002. While those corporate scandals triggered a massive public outcry, it is noteworthy that the total cost to the American public was far less than the trading abuses and excessive fees in the $7 trillion mutual fund industry. Thus, MFRA engenders a culture of compliance—employing tools from the landmark Sarbanes-Oxley Act.

> ***"State law did not impose meaningful standards of behavior. The SEC's attempts to encourage higher standards through the use of disclosure had not worked. Nor, despite all of the ink spilt on the subject, had the market generated meaningful limits on director behavior. Some type of regulatory intervention at the federal level was, therefore, inevitable. Congress stepped in and adopted the Sarbanes-Oxley Act of 2002."*** J. Robert Brown, *The Irrelevance of State Corporate Law in the Governance of Public Companies,* 38 U. Rich. L. Rev. 317 (January 2004).

MFRA requires adoption—by funds, investment advisers, and principal underwriters—of a code of ethics, which is reasonably designed to prevent violation of securities laws. This code must be disclosed to the public and reviewed annually. MFRA further requires appointment of a chief compliance officer, whose compensation is set by independent directors, who reports directly to independent directors, who may be an employee of the fund adviser, but who may be terminated only with the consent of the independent directors.

MFRA requires certain certifications to ensure careful monitoring and accountability. And finally, mindful of the singular contribution of whistleblowers to illumination of the current scandals, MFRA installs rigorous protections against retaliation for disclosing violations of securities laws or codes of ethics.

<u>Title 2: Fund Transparency</u>

✓ <u>Cost Consolidation and Clarity</u>

For the market to discipline excessively high-cost funds, investors must know total costs in comprehensive and accessible disclosures. Current regulations require disclosure of a fund's "expense ratio"—but that figure excludes significant costs borne directly by investors. These largely hidden "transaction costs" occur when the fund buys and sells securities in its portfolio. As the SEC recently noted in its Concept Release on transaction costs, "for many funds, the amount of transaction costs incurred during a typical year is substantial. One study estimates that commissions and spreads alone cost the average equity fund as much as 75 basis points." In other words, transaction costs may sometimes double the cost of investment. Additional transaction costs, such as market impact and opportunity costs, may cost even more.

MFRA enhances cost disclosure in several ways. First, MFRA requires standardized computation and disclosure of **two** cost ratios: the first is the expense ratio, designed to capture fund operating expenses, and the second is the transaction cost ratio, designed to capture the true costs of portfolio management. These two ratios must then be combined and disclosed as a single **"investment cost ratio."** MFRA recognizes that certain transaction costs, such as commissions and bid-ask spreads, are indisputable candidates for disclosure in the "transaction cost ratio"—while others, such as market impact and opportunity costs, may more precisely reflect simply the principal price a manager is willing to pay (or accept) for securities, and thus may not, in the ultimate judgment of the SEC, warrant computation and disclosure as part of the transaction cost ratio.

Additionally, MFRA assists investors confronting voluminous fund information with clear, simple, and at-least annual **actual dollar cost disclosure**. Including actual cost disclosure in the one document that investors *do* routinely review—their own statement—simplifies cost analysis for all investors and promotes genuine cost competition.

> ***"So how much did investors pay top stock and bond fund managers in the most recent 12 months? More than $35.2 billion, according to Max Rottersman, president of FundExpenses.com, a research firm that analyzes fund costs for institutional clients. ... And the total does not include sales charges on broker-sold funds. ... So, ... what is $35.2 billion? It is roughly equivalent to the gross domestic product of Ecuador."*** —*New York Times*, 11-30-03

Some say that mutual fund reform invites the proverbial "rock on jello"—and that a wily industry will react to reasonable restraints of one type of cost by simply shifting the cost to a new label. <u>MFRA stabilizes the mutual fund fee structure</u>. The SEC is directed to standardize all allowable types or categories of fees, expenses, loads, or charges borne by fund shareholders. New costs cannot be created without an SEC determination that the new cost is in the best interests of shareholders of (i) a particular fund, (ii) certain types of funds, or (iii) funds generally. Everyone, including (or perhaps especially) the mutual fund industry, acknowledges the critical importance of restoring investor trust. By stabilizing the fee structure—and building in safeguards against cynical manipulation of complex fee structures—MFRA takes the long stride toward ensuring sustained investor confidence.

Finally, MFRA addresses financial literacy by requiring clear explanation and definition of all types of fees, charges, expenses, loads, commissions, and payments—as well as where investors may find additional information about them.

✓ **<u>Advisor Compensation and Ownership of Fund Shares</u>**

The Sarbanes-Oxley Act turned the spotlight on executive compensation—not merely to satisfy casual investor curiosity but to *deter conflicts of interest and distorted incentives*. MFRA does the same—albeit only with respect to portfolio management. If, as a consequence of disclosure, fund managers feel more motivated to earn their compensation, so much the better for investors. It may likewise be relevant whether fund managers are invested in the very funds they manage—and investors are entitled to know. Finally, insider transactions in the fund must be disclosed to the board of directors. Insider transactions are not *per se* problematic—quite the contrary, it may be a strong *positive* to have fund managers invested in the funds they manage. But to help deter potential abuses, the board should be informed of insider transactions. (In Title 3, MFRA prohibits **short-term** insider transactions to prevent abusive rapid trading by insiders.)

✓ **<u>Broker Confirmations</u>**

MFRA requires point-of-sale disclosure of the source and compensation to be received by the broker in connection with the transaction. Such disclosure is standard with other financial instruments—and broker/dealers can do the same for mutual fund investors. Significantly, however, as discussed below, MFRA *vastly simplifies broker disclosure by prohibiting certain conflict-riddled broker-compensation practices—such as revenue sharing, directed brokerage and soft-dollar arrangements—that artificially inflate broker commissions and introduce distorted sales incentives.*

✓ **<u>Breakpoint Discounts</u>**

Breakpoint discounts are essentially "volume discounts"—reductions in sales charges for purchases beyond certain thresholds. The policies for applying breakpoint discounts, however, can be complicated. For example, an investor may be entitled to a breakpoint discount based on total shares purchased over a period of time, or from different accounts, or together with other family members.

The National Association of Securities Dealers (the self-regulatory organization of brokers and dealers) estimated that more than $86 million in breakpoint discounts were not correctly applied by broker/dealers in 2001 and 2002, which indicates investor overcharges in one out of every five eligible transactions.

MFRA requires more prominent disclosure of information and policies about breakpoint discounts, so that investors are better equipped to help themselves. Perhaps more importantly, as discussed below under Customer Information from Account Intermediaries, MFRA bridges one critical gap in the uniform application of breakpoint discount policies.

✓ **Portfolio Turnover Ratio**

Many investors do not understand that the benign, or even enticing, term—"actively managed"—may conceal inordinately high transaction costs. When fund managers buy and sell securities in the fund portfolio, they incur transaction costs, such as commissions, bid-ask spread costs, market impact costs and opportunity costs. All of these costs diminish performance. To be sure, some actively managed funds do very well. But investors have a right to know, in straightforward terms, just how "actively" the portfolio is managed. The portfolio turnover ratio is a good indicator. MFRA requires prominent disclosure of the portfolio turnover ratio, as well as explanation of its meaning and implications for cost and performance. Thus, MFRA takes no legislative position on the propriety of active or passive management—but merely equips investors with clearer and more comprehensible information so that they can make decisions based upon their own investment objectives.

✓ **Proxy Voting Policies and Record**

Mutual funds are a seven-trillion-dollar industry—and control nearly one-third of U.S. equity voting power. *See* Alan R. Palmiter, *Mutual Fund Voting of Portfolio Shares: Why Not Disclose?* 23 Cardozo L. Rev. 1419, 1421 (March 2002). That is an impressive stake in U.S. corporate governance. Such enormous power is ill-suited to the shadows. MFRA requires disclosure of the fund's proxy voting record, as well as any proxy voting policies that may better equip investors to align their mutual fund purchasing with their corporate governance preferences.

✓ **Customer Information from Account Intermediaries**

Rules against market timing, application of breakpoint discounts, imposition of redemption fees on short-term trading—all of these salutary practices work *only if the fund knows the identity and trading activity of its investors*. But many financial intermediaries, including broker/dealers, convey aggregate trading information to funds through "omnibus accounts," consisting of multiple anonymous fund customers. Failure of a fund to know its own investors seriously impairs fair and uniform enforcement of its trading policies.

As Niels Holch, Executive Director of the Coalition of Mutual Fund Investors, stated in a December 12, 2003 letter to the SEC, "individual, long-term shareholders will not be guaranteed equal and fair application of fund policies, procedures, fees and charges, unless and until each mutual fund is provided information from its intermediaries about the identity of all shareholders in omnibus accounts and the individual transactions engaged in by those shareholders."

MFRA requires that intermediaries convey to funds the basic customer identification and trading activity information needed to enforce fund policies fairly and uniformly. However, such information may *only* be used to enforce fund policies, and all proprietary rights to such customer information under state and federal law are preserved.

✓ **Advertising**

Mutual funds fairly compete for investor attention and purchase. Indeed, because a certain percentage of investors can be expected to sell their shares every year, mutual funds want to meet these redemptions with new purchases so that "net redemptions" do not force funds to sell off too many portfolio assets. Advertising is one way to stimulate demand. However, some funds engage in questionable claims. Performance advertising, in particular, is fertile territory for misleading investors. Former SEC Chief Economist Susan Woodward put the matter bluntly in a recent *Wall Street Journal* op-ed: "A fund's past performance provides zero guidance about its future performance."

MFRA directs the SEC to address several aspects of performance advertising, including unrepresentative short-term performance, performance based upon undisclosed non-recurring or improbable events, and performance based upon technically accurate but incomplete or misleading data.

Truthful and non-misleading advertising is a right guaranteed by the United States Constitution. MFRA respects that right—with requisite emphasis on "non-misleading."

Title 3: Fund Regulation and Oversight

> *"[I]n our laudable efforts to improve public disclosure, we too often appear to be mistaking more extensive disclosure for greater transparency."*
>
> **—Alan Greenspan, Federal Reserve Chairman, May 8, 2003**

MFRA is truly structural reform. It does not merely mandate yet more "disclosure" in an industry already saturated with voluminous disclosure rules. MFRA's essence is *not* the regulatory regime that it creates, but the free market forces that it liberates. MFRA fuels a competitive mutual fund market by making its transactions honest and comprehensible. Market distortions occur when market players can obscure their activities and mislead consumers. Examples addressed in MFRA include **12b-1 fees, revenue sharing, soft-dollar arrangements,** and **directed brokerage**. MFRA lifts the veil of mislabeled and misleading transactions, creates true transparency and promotes meaningful competition. Merely demanding more disclosure—while salutary up to a point—risks encyclopedic and incomprehensible data dumps on investors.

A more honest and straightforward, and thus more vibrantly competitive, mutual fund market well serves the 95 million Americans who entrust their savings to mutual funds—and not incidentally, well serves the robustness of the mutual fund industry itself. Mercer Bullard, founder of Fund Democracy and sponsor of the recent Fund Summit in Oxford, Mississippi—where 11 lawmakers, regulators, and industry leaders convened to debate the direction of the industry—said of his panelists that they all share the aspiration for "America's favorite retirement vehicle, a great institution, a great industry, to provide the best service it can for America's investors." That aspiration permeates the Mutual Fund Reform Act of 2004. And central to that aspiration is the recognition that scandal, cynicism, and revolt are inevitable consequences of confusing and opaque cost schemes.

Time magazine notes, for example, that investors have been flocking to "separately managed accounts"—customized investment vehicles with minimum investment requirements. One noteworthy virtue, writes *Time*, of separately managed accounts: "**fee transparency**. Typically, separate-account managers charge a flat annual fee of 1.5% to 2.5% of assets. In most cases there are none of the loads, redemption fees, 12b-1 marketing fees, trading commissions, or soft-dollar costs that proliferate in the mutual-fund world and drive annual expenses far higher than disclosed levels." The vexation here is not merely with the "hiddenness" of many of these costs—*but with the very existence of such a confusing and cynical welter of ways to siphon investors' money.* MFRA is a decisive answer to that vexation—and an answer that well serves all Americans, not only the ones who can afford the minimum investment requirements of separately managed accounts and hedge funds.

✓ <u>Asset-Based Distribution Expenses (Rule 12b-1)</u>

A sales load was once an honest sales load. Then came **Rule 12b-1**. Designed in 1980 by the SEC, Rule 12b-1 permitted funds to use fund assets, *temporarily*, for distribution and marketing—to (1) stimulate purchases and thus redress temporary net redemptions, and (2) increase the size of the fund so that cost savings from economies of scale could be passed along to investors. The theory was sound. But Rule 12b-1 has wandered far from its original moorings. It has become a *permanent* fixture of most fee schedules, and can cost investors up to 1% of their investment every year. Over the life of a retirement plan, that 1% can cost an investor 35% to 40% of his or her retirement income. And it does not appear that investors have benefited from economies of scale.

Nearly two-thirds of 12b-1 fees end up in the hands of brokers. In other words, 12b-1 fees have become **disguised loads**.

Fund management properly includes fund distribution. MFRA accordingly places the distribution duty where it belongs. MFRA gets funds out of the distribution business by prohibiting asset-based distribution fees (such as 12b-1 fees)—but, importantly, <u>amends the Investment Company Act of 1940 to make clear that fund advisers may use their adviser fees for distribution expenses</u>. What happens when fund advisers use their own profits—instead of tapping directly into investors' money—for distribution expenses? Distribution expenses become very reasonable.

In negotiating their fees with an empowered and independent board, advisers will now have to make the case that their costs necessarily include specified distribution expenses. And once advisers receive their fee, distribution expenses will, dollar for dollar, reduce adviser profits. That dynamic locates the incentive to keep distribution expenses reasonable precisely where it belongs. And MFRA incorporates one additional structural check on unreasonable distribution expenses—one that goes to the heart of the inherent conflict between fund managers and fund shareholders. If the board of directors determines that certain distribution expenses are not in the best interests of existing shareholders, then the board may stipulate that no part of the adviser's fee may be used for that expense. A distribution expense designed solely to pump up the asset base of an already large fund, for example, and not otherwise necessary to meet net redemptions, would obviously well-serve the adviser, who collects a percentage of net assets, but not necessarily existing shareholders.

Importantly, MFRA does *not* prohibit distribution expenses or sales charges. Charging a load (subject to NASD rules) is fully justified—<u>but call it a load, make it account-based, and don't disguise it in a permanent asset-based distribution fee</u>.

✓ <u>Indefensible Brokerage Practices</u>

There is a reflexive preference in approaching our markets for demanding "disclosure" as a total solution—and sometimes as a total substitute for clear ethical and practical judgments. But some practices cannot be rationally defended. And some clear rules enrich and enliven our markets. We do not tell football players that they can clip, hold, or jump offside as long as they do so openly. We should not tell fund advisers and broker-dealers that they may misuse investor money with soft-dollar arrangements, revenue sharing and directed brokerage as long as they file reports. "Disclosure" of these practices merely precipitates an even more confusing blizzard of incomprehensible information—and even further alienates average investors from meaningful participation in the mutual fund market. As former SEC Chairman Arthur Levitt aptly remarked, "[t]he law of unintended results has come into play: Our passion for full disclosure has created fact-bloated reports, and prospectuses that are more redundant than revealing."

Three practices—soft dollar arrangements, revenue sharing, and directed brokerage—ought not clutter any mutual fund prospectus. And neither funds nor fund advisers should be spending time and money crafting elaborate disclosures and justifications of ultimately indefensible practices. <u>By simply prohibiting these practices, MFRA vastly simplifies the disclosure regime, and benefits all stakeholders</u>.

✓ **<u>Revenue Sharing</u>**

Kiplinger.com commentator Steven Goldberg calls revenue sharing "the fund industry's most insidious practice … It sounds benign, but it boils down to **mutual fund payola**, giving brokers, financial planners or other financial advisers a little extra compensation if they sell a load fund to you. That is, a little something extra over and above the load you're already paying." A "little something"? Annual revenue sharing payments to brokerage firms total an estimated **$2 billion**. And investors listening to a broker's "advice" may not realize that the broker's "Preferred List" of mutual funds is a function of this payola.

Moreover, revenue-sharing, like nearly two-thirds of 12b-1 money, goes to brokers, as a presumptive "distribution" expense—yet revenue sharing effectively circumvents the elaborate rules capping 12b-1 fees at no more than 1% of assets. The only difference is that revenue sharing payments are made by the fund adviser, out of the adviser's fee—which of course comes from the fund assets.[1] Consumer Federation of America, along with several consumer groups that have endorsed MFRA, note the negative impact of revenue sharing, despite the fact that such payments come from the adviser rather than directly from fund assets: "At best, by eating into the manager's bottom line, the payments may reduce the likelihood that the management fee will be reduced in response to economies of scale. At worst, fund managers will pass along those costs to shareholders in a form that is even less transparent than directed brokerage payments."

Revenue sharing aggravates the conflicted interests of both brokers and fund advisers at the expense of fund shareholders. On the one hand, brokers get payola out of the fund adviser's management fee—and peddle funds they're paid to peddle without the requisite regard for the investor's best interests. On the other hand, fund advisers collectively give away $2 billion of their evidently abundant fees to promote yet further sales of fund shares, which increases fund assets, which increases the adviser's fee, which makes more money available for payola. MFRA breaks this investor-hostile circular enrichment, and restores rational solicitude for investors' money.

[1] The SEC has held that fund assets are indirectly used for distribution "if any allowance were made in the investment adviser's fee to provide money to finance distribution." *See* Investment Company Act Release No. 16431 (June 13, 1988) at text accompanying note 124.

✓ **<u>Soft Dollar Arrangements</u>**

Under soft dollar arrangements, brokers inflate their commissions on portfolio trades and give credits to fund managers in return. These credits are then used for research services, software, hardware, and other manager "overhead"—which directly and immediately benefit fund managers, but only indirectly, if at all, benefit the shareholders who pay for them. Moreover, these direct costs to shareholders are not even reflected in the expense ratio, because commissions—as with all transaction costs—are excluded from the expense ratio. Thus, by using surreptitious soft dollars, instead of honest hard dollars, the industry effectively hides yet another significant cost of mutual fund investment.

Soft dollars also effectively suppress entire markets. Soft dollar arrangements distort the markets in both trade executions and products and services "purchased" with soft dollars—because there is little or no meaningful price negotiation or competition in these markets. Why would there be? Fund advisers *use investors' money*, through artificially inflated brokerage commissions, and competition inevitably and severely suffers when demand is driven by *someone else's money*.

> **Senator Collins:** ***Is the answer a ban on soft dollars?***
>
> **John Bogle:** ***I think ultimately the answer is yes, there should be a ban on soft dollars. It comes down to a very simple principle, and that is, it is amazing how cheap everything you buy is if you buy it with other people's money.***
>
> —Senate Financial Management Subcommittee Hearing, January 27, 2004

Managers should pay for their overhead out of their management fee instead of forcing shareholders to pick up the tab through artificially inflated brokerage commissions. MFRA effectively "unbundles" the commission dollar. All stakeholders can then more readily assess the true cost of trade execution. And industry research and other unbundled services, now purchased with hard dollars through traditional negotiation, will acquire more authentic market values. Some services will thrive; others will crater. That happens when the market is healthy and transparent, and the demand side cannot spend someone else's money.

MFRA's treatment of soft dollar arrangements, like its treatment of 12b-1 fees, is inspired not by intent to regulate private transactions—but to label such transactions honestly. Just as a load is a load, and should be charged as such, so research expense should be the fruit of competitive negotiation for research—not the backdoor largesse of forcing investors to pay inflated brokerage commissions.

John Montgomery of Bridgeway Funds perfectly summarized the justification for banning soft dollars (as opposed to mandating yet more elaborate "disclosures") when he testified before the House Capital Markets Subcommittee in March 2003: "The bottom line: Congress should not work to improve disclosure of soft dollars; it should simply stop the practice altogether. Ultimately, this will improve the quality of decisions made on things soft dollars buy, save shareholders some money, and greatly reduce the time that advisers, auditors, regulators, and lawyers spend trying to document the fairness of a firm's practice."

> ***"As a fellow Texan said, 'If you see a snake, just kill it—don't appoint a committee on snakes.'"***
>
> —John Montgomery, Bridgeway Funds, House Capital Markets Subcommittee Hearing, March 12, 2003, advocating a ban on soft dollars

✓ **Directed Brokerage**

Directed brokerage is the practice by a customer (such as a mutual fund or affiliated person) of directing brokerage business to a particular broker or dealer in exchange for services other than trade executions. Examples of such services include sales support (as with revenue sharing), or administrative services. Directed brokerage seems benign—but the effect is yet a further hidden cost to investors, in the form of higher brokerage costs. Once brokerage is "directed" by a customer, the manager's ability to obtain better or less expensive execution from a different broker is disabled.

Last December, Louis Harvey, president of Dalbar Inc., a Boston-based research company, told *Investment News* that the practice of directed commissions obscures what best execution actually costs. Thus, funds pay more than retail investors to buy and sell stock. "If the practice is done away with, it will be replaced by competitive forces."

In recognition of the indefensibility of the practice, several funds announced recently that they are ceasing directed brokerage arrangements. The industry's leading trade association, the Investment Company Institute, likewise recently advocated prohibiting directed brokerage.

✓ **Late Trading**

Late trading is already illegal. The policy problem with late trading is *not* with the law, but with the practice of processing some orders after the calculation of "net asset value"

(NAV), and thus share price, for that day. Typically, mutual funds calculate their NAVs as of 4:00 p.m. EST, the closing time of the major U.S. stock exchanges. The SEC's Rule 22c-1 requires funds to calculate NAV at least once a day. All orders to buy or sell mutual fund shares received on a particular day are executed at the same price. Under Rule 22c-1, orders to buy or sell mutual fund shares must be executed at a price based on the NAV next calculated after receipt of the order. The Rule therefore requires that orders for most funds received after 4:00 p.m. be executed using the next day's price.

"Late trading" refers to the practice of submitting an order to buy or redeem fund shares after the 4:00 p.m. pricing time yet receiving that day's price rather than the price set at 4:00 p.m. the following day, or placing a conditional order prior to 4:00 p.m. that is either confirmed or canceled after 4:00 p.m. A late trader typically seeks to trade profitably on developments after 4:00 p.m., such as earnings announcements or events in overseas markets. As noted, late trading is already illegal.

But when is an order to buy or sell "received" under Rule 22c-1—when the fund receives the order, or when an intermediary (such as a retail broker or a 401k administrator) receives the order? To date, the SEC has interpreted "receipt" as used in Rule 22c-1 to include receipt of an order to buy or sell mutual fund shares by retail brokers and other intermediaries. Investors may thus place orders to buy or sell fund shares through broker-dealers, through retirement accounts and through variable insurance carriers, confident that they will receive that day's price for the shares. According to some estimates, mutual funds receive over half of their orders in the form of aggregated orders provided by intermediaries after 4:00 p.m. The SEC is currently reexamining its rules.

MFRA directs the SEC to enforce the current strict terms of Rule 22c-1—but gives the SEC the authority to fashion rules that accommodate investors transacting through their preferred intermediaries. For example, if it can be verified that intermediaries received their orders from their customers before 4:00 p.m.—and the intermediaries have systems in place that ensure compliance and permit independent verification—then the rules developed by the SEC may permit processing of such orders by the mutual fund after the 4:00 p.m. close. MFRA's ultimate purpose is two-fold: (1) preserve the appeal of mutual funds as a flexible and investor-friendly vehicle for long-term investment; and (2) prevent the unfair dilution of mutual fund value by short-term predators.

✓ **<u>Market Timing</u>**

"I have no interest in building a business around market timers, but at the same time I do not want to turn away $10-20m," wrote Richard Garland, then head of Janus Capital Groups international business to a colleague. Thus did Mr. Garland succinctly describe the sirenic tug that triggered the current industry scandals.

"Market timing" refers to a form of trading mutual fund shares in which short-term investors seek to exploit a perceived difference between the fund's calculated NAV and the actual underlying value of the fund's portfolio holdings. As earlier noted, funds must calculate their NAV and set their share price at least once a day—typically at 4 p.m. EST. Sometimes, the closing price of a portfolio security at 4:00 p.m. EST may not reflect its current market value. For example, an event may occur or news may be released after 4:00 p.m. that can reasonably be expected to have an impact on a security's price when trading resumes. Securities that trade overseas are especially fertile ground for market timers, because many hours may elapse between the close of trading in an overseas market and the calculation of the fund's NAV.

Market timers seek to reap quick profits in mutual fund shares from these arbitrage opportunities. A market timer seeks to purchase a fund's shares based on events occurring before the fund's NAV calculation. For example, a market timer might guess that rising prices in the U.S. securities markets indicate likely higher prices in overseas markets the next day. The market timer would purchase mutual fund shares that reflect stale closing prices in overseas markets. The market timer would then redeem the fund's shares the next day, when the fund's next NAV calculation would reflect the presumably higher prices in overseas markets. The market timer seeks to make a quick and relatively risk-free profit.

Market timing is not specifically illegal—hence the conundrum facing many fund advisers and other industry players. But many mutual funds discourage market timing, often resolutely, because timers take their profits directly out of the value of shares held by long-term investors—*i.e.*, the very category of the 95 million American mutual fund investors most likely to have entrusted retirement and college savings to mutual funds. Sale of fund shares at an artificially low price based on stale information dilutes the ownership interest of existing shareholders. Similarly, redemption of fund shares at an artificially high price dilutes the interest of remaining shareholders.

Some question whether market timing strategies really work. Importantly, however, merely the perception that market timing works, and is available, encourages rapid trading, which burdens funds *regardless of whether the underlying timing strategy works.* A fund forced to meet multiple redemptions from rapid trading activity may be obliged to keep more fund assets in cash or sell more portfolio securities to meet such redemptions —which increases the fund's transactions costs at the expense of existing shareholders.

As noted earlier, MFRA's overriding purpose with respect to trading abuses is two-fold: (1) preserve the appeal of mutual funds as a flexible and investor-friendly vehicle for long-term investment; and (2) prevent the unfair dilution of mutual fund value by short-term predators. MFRA thus addresses the problem of market timing with solicitude for the long-term investor, and steers market timing away from the mutual funds. MFRA provisions include:

- Requiring explicit disclosure in fund offering documents of market timing policies and specific procedures to enforce policies—and requiring that such a policy be deemed a "**fundamental investment policy**" (which cannot, under the Investment Company Act of 1940, be changed without a shareholder vote).

- Requiring that any fund that declines to adopt enforceable restrictions on market timing must so advise prospective investors in its prospectus, advertising, and otherwise as determined by the SEC.
- Requiring regular **fair value pricing—**so that NAV more fairly reflects actual portfolio value, and opportunities for predatory arbitrage are diminished.
- Requiring mandatory **redemption fees** for short-term trading (which fees are deposited back into fund assets, thus benefiting all shareholders, while discouraging arbitrage by increasing its cost).
- Permitting (but not requiring) redemption fees exceeding two percent for short-term transactions that are unfair to shareholders.

Title 4: Studies

✓ **Learning from Experiences: Further Study**

MFRA seeks to perpetuate the dialogue and to preserve the wisdom gathered from hard experience. Several studies are directed:

- A study and report by the SEC on the consequences of the inherent conflict of interest confronting fund advisers, the extent to which legislative or regulatory measures could minimize this conflict of interest, and the extent to which legislative or regulatory measures could incentivize internal management of mutual funds.
- A study and report by the General Accounting Office (GAO) on coordination of enforcement efforts between SEC headquarters, SEC regional offices, and state regulatory and law enforcement entities.
- A study and report by GAO on the SEC's current organizational structure with respect to investment company regulation, and whether that organizational structure sufficiently credits the importance of mutual fund oversight to the 95 million mutual fund investors in America, and whether certain features of that organizational structure, such as the separation of regulatory and enforcement functions, conduce to optimal regulatory understanding of current practices.
- A study and report by the SEC on trends and causes in arbitration claims since 1995, and means to avert claims.
- A study and report by the SEC on whether additional regulation of alternative investment vehicles, such as hedge funds, is appropriate to deter recurrence of trading abuses, manipulation of regulated investment companies by unregulated investment companies, or other distortion that may harm investors in shares of registered investment companies.
- A study by the SEC, coupled with regulatory and acquisition initiatives as appropriate, designed to enhance the role of the internet in educating investors and providing timely information about laws, regulations, enforcement

proceedings and individual funds. Further, the SEC should study the feasibility of mandating that funds have websites, and disclosure thereupon of material filings and fund information. Further, the SEC should take necessary steps to ensure that its EDGAR system is user-friendly and contains a search-engine that facilitates expeditious location of material information in the SEC's database.

The Mutual Fund Reform Act of 2004: Reforms That Finally Put Investors First